Accountability of independent directors: Evidence from firms subject to securities litigation

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Abstract

We examine which independent directors are held accountable when investors sue firms for financial and disclosure-related fraud. Investors can name independent directors as defendants in lawsuits, and they can vote against their reelection to express displeasure over the directors’ ineffectiveness at monitoring managers. In a sample of securities class action lawsuits from 1996 to 2010, about 11% of independent directors are named as defendants. The likelihood of being named is greater for audit committee members and directors who sell stock during the class period. Named directors receive more negative recommendations from Institutional Shareholder Services, a proxy advisory firm, and significantly more negative votes from shareholders than directors in a benchmark sample. They are also more likely than other independent directors to leave sued firms. Overall, shareholders use litigation along with director elections and director retention to hold some independent directors more accountable than others when firms experience financial fraud.

1. Introduction

We examine accountability of independent directors when firms face litigation for corporate financial fraud. Shareholders have two publicly visible means for holding directors accountable: They can sue directors, and they can vote against director reelection. We use the incidence of independent directors being named as defendants in securities class action lawsuits and shareholder votes against those directors to assess which directors are held accountable for the violations that lead to the lawsuits.

Independent directors named as defendants in securities lawsuits (hereafter named directors or named defendants) face the possibility of financial and reputational harm, lost time, and emotional distress. Their personal financial liability from lawsuits is limited in the US (Black, 2013). This quote by Toby Myerson, partner at Paul, Weiss, Rifkind, Wharton & Garrison LLP, speaking at the 2005 Harvard Law School Symposium on Director Liability, quoted in Bebchuk (2006, p. 1036), reflects this concern: “Most people who consider acting as directors don’t want to have their name in the caption of the lawsuit. They don’t want to have to establish that they didn’t do anything wrong. They don’t want to have to be deposed and spend their time dealing with the litigation. Life is too short. People are busy; they have other things to do.”
We expect shareholders to continue their accountability efforts toward named directors by voting against those directors’ reelection. We find that ISS, the leading proxy adviser, and shareholders view named directors negatively. These directors have a greater percentage of withheld votes (5.47% greater) compared with directors in a matched sample of non-sued firms. The mean matched firm negative vote (5.03%) is similar to the 5.73% negative vote for the average director shown in Cai, Garner, and Walking (2009). The mean negative vote for named directors (10.50%) is thus about twice that for matched firm directors and a benchmark from prior research. Non-named directors of sued firms have a modestly greater negative vote (1.10% greater) than directors of non-sued firms.

Accountability can also be reflected in greater turnover for named directors. In our study, these directors are more likely to leave a sued company within two years of the lawsuit than other directors in the same firm and the matched sample. The marginal effect of being named on director turnover is 3.62%, which implies a 30% higher rate than the unconditional probability of turnover in our sample. The propensity of named directors to leave the board is greater in lawsuits that are not dismissed (the settled cases) and for audit committee members. The likelihood of leaving increased for both named and other directors in sued firms after 2002 (post-SOX), which we use as a proxy for greater governance sensitivity.

Naming directors as defendants can also have economic implications for lawsuit outcomes. We expect a positive association between directors being named as defendants and the likelihood that a lawsuit will not be dismissed, reach a settlement faster, and settle for more, based on two non-mutually exclusive hypotheses. First, as the Enron and WorldCom cases suggest, independent directors can reach a settlement faster, and settle for more, based on two non-mutually exclusive hypotheses. First, as the Enron and WorldCom cases suggest, independent directors can

irrespective of litigation, shareholders can also hold directors accountable by voting against them. Recent research (Cai, Garner, and Walking, 2009) finds that shareholder votes are significantly related to director performance and that boards act as if they respond, even if the economic magnitude of the negative votes is small.

We recognize that a lawsuit filed for securities law violation does not imply that a fraud occurred. Consistent with prior research, in the absence of a foolproof way to identify fraud and director intent, lawsuits...
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